

ACCOUNT ADMINISTRATION: COLLECTIVE INVESTMENT FUNDS

A collective investment fund is a trust fund maintained by a bank exclusively for the collective investment and reinvestment of money of several trust accounts. Synonyms for the term "collective investment trust funds" are; common trust funds, group trusts, Regulation 9 funds or pooled funds. The fund is separate entity which has its own tax number and administrative requirements. The governing instrument for a fund is called a "plan" which is similar to a trust agreement and in some institutions is titled as a "Declaration of Trust." Investments in a fund are referred to as units and, like a share of stock, represent a proportional ownership interest in all assets comprising the fund. The accounts holding investments (units) in the fund are called participants.

Collective investment funds offer advantages to both the participants and the bank. A major advantage is that the funds permit a wider degree of diversification for both large and small accounts. The use of funds usually reduces transaction costs and brokerage commission since larger purchases and sales can be effected more economically. Collective funds generally provide a greater scope of investment opportunities and permit regular investment by the participants resulting in less idle cash in the accounts. It also allows management to concentrate its investment decision-making and research efforts.

There are disadvantages to collective funds. A serious concern to participants involves accumulated capital gains within a fund. Units must be sold in order to distribute proceeds to a participant, which may cause a capital gains tax liability to withdrawing participants. Gains and losses for tax purposes are computed on individual holdings within the fund when they are sold. Therefore, while participants may not realize an increase in the value of their investment, they may incur a tax liability resulting from investment transactions within the fund. Also, some reduction in liquidity to the trust accounts results, as an account may only withdraw from a fund as a valuation dates, customarily monthly or quarterly.

There are also disadvantages to the bank. The majority of costs involved in establishing a common trust fund must be borne by the bank including counsel fees for drafting the agreement, cost of setting up new books and any staffing requirements. Also, there may be more pressure on the fund's investment adviser to achieve high performance as the results achieved by one bank in fund investment is easily compared with fund performance attained by other institutions in the operation of like funds.

A. TYPES OF COLLECTIVE INVESTMENT FUNDS

There are two general types of collective investment funds: a common trust fund maintained by the bank exclusively for the collective investment and reinvestment of monies contributed thereto by the bank in its capacity as trustee, executor, administrator, guardian or custodian under a uniform gifts to minors act sometimes referred to as 9.18(a)(1) funds; and a pooled fund consisting solely of assets of retirement, pension, profit sharing, stock bonus or other trusts, exempt from Federal income taxation under the Internal Revenue Code, sometimes referred to as 9.18(a)(2) funds. It should be noted that agency accounts are prohibited from participating in common trust (9.18(a)(1)) funds.

Collective funds may be characterized by the type of asset or investment objective. One or more of the following types may be found in a trust department depending on its size and the diversity of accounts and objectives: (1) Equity Fund. Assets consist primarily or totally of common stocks to achieve market appreciation and produce some current income; (2) Diversified or Balanced Fund. Typically such funds have a balance of equity and fixed income securities providing a diversification of assets by asset type. Such funds seek capital appreciation with a regular stream of income; (3) Fixed Income Fund. Holdings are comprised totally or predominantly of bonds, preferred stocks, mortgages and other property from which the income return is fixed; (4) Municipal Bond or Tax-Exempt Bond Fund. Comprised of State and municipal bonds which provide income exempt from Federal taxation and state taxation for residents of the state of issue of the securities; (5) Real Estate Investment Fund. Fund invested primarily in real estate equities; (6) Short Term Investment Fund (STIF). Fund established for investment of trust assets on a

temporary basis with the objective of liquidity; (7) Mortgage Fund. Fund consisting predominantly of mortgages; (8) Foreign Securities Investment Fund. Fund primarily composed of foreign securities and could be an equity, fixed income or balance fund; (9) Index Collective Investment Fund. The fund could be an index equity or index fixed income fund. The funds are invested in securities tied to a particular securities index such as Standard & Poor's New York Stock Exchange Index or Dow Jones Industrials; (10) Discretionary Fund. Investments are made at the discretion of the trustee permitting broad flexibility; and (11) Covered Call Option Fund. A fund which permits the writing of covered call options.

B. ADMINISTRATION

Each common trust fund is considered a tax entity. In order to maintain its tax exemption it must be operated in conformity with the regulations of the Internal Revenue Service. Section 584 of the Internal Revenue Code of 1954 pertains to the operation of common trust funds by banks acting, either alone or with one or more co-fiduciaries, in the capacity of executor, administrator, guardian or trustee (Section 9.18(a)(1) fund) One of the conditions for qualification for Federal tax-exempt status of a common trust fund is that it be operated in conformity with the provisions of Section 9.18 of Regulation 9 of the Comptroller of the Currency. This condition applies to all banks.

Section 9.18(a)(2) of Regulation 9 deals specifically with common trust funds established for the sole participation of employee benefit accounts or other trusts (such as charitable trusts) exempt from Federal income taxation under Internal Revenue Code Section 401(a). Such trust are tax-exempt under Section 501(a) of the Internal Revenue Code of 1954, as amended. Under Internal Revenue Ruling 81-100 (formerly Revenue Ruling 56-267) such pooled funds need not comply with the requirements of Section 9.18 unless provisions of the plan provide for such compliance. Note: Employee benefit accounts administered under agency agreements may participate in such funds as provided in Revenue Ruling 81-100 if they incorporate adoptive language in their agreement. Such language simply states that the plan of the common fund is considered a part of the agency agreement.

The full text of Section 9.18 of Regulation 9 is included in Appendix C-8 of this Manual. Various precedents and opinions of the Comptroller of the Currency related to specific problems that have arisen in common trust fund operations are included in Appendix C-9 for information and reference.

Paragraph (b) of Section 9.18 consists of 14 subparagraphs which detail the requirements for establishing and administering a common trust fund. The following constitute generally accepted practices as well as many of the requirements of Regulation 9.18.

The Plan - Each common trust fund must be established and maintained in accordance with a written plan. The plan should be examined and approved in writing by competent legal counsel and approved by resolution of the bank's board of directors. Specific plan requirements for funds established under Section 9.18 are discussed in Section 9.18(b)(1). A copy of the plan must be filed with the Comptroller of the Currency. The written plan should include appropriate provisions for the following: Investment powers and general statement of the investment policy of the bank with respect to the fund; Allocation of income, profits and losses; Terms and conditions governing the admission or withdrawal of participations in the fund; Auditing of accounts of the bank with respect to the fund; The basis and method of valuing assets in the account; The minimum frequency for valuation of the assets of the fund; The period following each such evaluation date during which admissions to, or withdrawals from the fund may be made (which in usual circumstances should not exceed 10 business days); The basis upon which the fund may be terminated; and Such other matters as may be necessary to define clearly the rights of participants in the common trust fund. A copy of the plan should be available for inspection at the principal office of the bank during banking hours.

Operational Rules - Participation in a common trust fund should be at the direction of the Trust Committee after it has been determined that none of the common trust fund investments are illegal investments for a particular trust. Funds must be valued periodically (not less frequently than once every three months) at market value or, if such valuation is not readily ascertainable, then at a fair value determined by the trustee. No participants

should be permitted to be admitted or withdraw except on the basis of such valuation and on such valuation date and unless a written request for such action shall be entered in the fiduciary records of the bank on or before valuation date in such manner as the board of directors shall prescribe. The bank may require notice of up to one year for withdrawal from certain funds invested primarily in real estate or other assets not readily marketable. No request or notice can be cancelled or countermanded after the valuation date. Distributions to withdrawing participants may be made in cash or ratably in kind. An audit must be performed at least once during each period of 12 months by auditors responsible only to the bank's board of directors. A financial report based on the audit must be furnished or made available at no charge to each person who would receive an accounting from each participating trust account and must contain the following: A list of investments at both cost and current market value; Investment changes for the period reflecting purchases (with costs) and sales (with profit or loss); Income and disbursements since the last report; and Notation of an defaulted investments. Advertising of common trust funds established for personal trust accounts is prohibited. The bank must have exclusive management of the fund. No certificates or other document evidencing a direct or indirect interest in common trust funds may be used. If fees are charged for the management of common trust funds, they can be no more than an account would pay if it was not participating in the fund.

Conflicts of Interest - The bank must not have any interest in a collective investment fund other than in its fiduciary capacity. Temporary net cash overdrafts are permissible providing a net cash overdraft caused when redemptions exceed participations be cleared within 10 business days of the valuation date. Overdrafts caused by several investment transactions with different settlement dates or when disbursements and receipts take place on different dates should be covered within 5 business days. The bank must not sell assets to or purchase assets from a collective investment fund. No assets of a fund may be invested in the bank's own stock or its obligations including time and savings deposits, unless the latter comprise funds awaiting investment or distribution. Whether or not a deposit is awaiting investment or distribution is largely determined by the intent of the trustee at

the time of making such deposit. The Comptroller of the Currency has generally held that time deposits should have a maturity of 91 days or less. No loans may be made by the bank on the security of a participation in a fund. If the bank does acquire an interest in a participant in a fund through a creditor relationship, then the participation must be withdrawn at the next valuation date.

Investment Consideration - In administration of funds created pursuant to Section 9.18(a)(1), bank procedures should provide for the following: No units of participation may be held by an agency account; No participating account may hold more than a 10% interest of the current market value of the fund; The investment in the securities of any one issuer (including mutual funds), at the time the last investment was made, may not exceed 10% of the fund's market value, with the exception of direct or fully guaranteed obligations of the United States; and The bank must maintain adequate liquidity in cash or readily marketable securities.

In addition to the administration requirements noted above, there are additional administrative requirements for several of the special investment funds.

Short Term Investment Funds - STIF's are permitted to be operated under 9.18(c)(5) of the Comptroller of the Currency's Regulation 9 if such funds include the following provisions; at least 80% of the investments must have a maturity date not exceeding 91 days from the date purchased, principal is valued at cost, assets must be held to maturity under usual circumstances, and at least 40% of the fund must consist of cash, demand obligations and assets that will mature on the fund's next business day after effecting the entries and withdrawals. The valuation process must be completed before the fund opens for admissions and withdrawals. A variable amount note may be used to meet the 40% liquidity requirement. For the purposes of the required annual financial statement, assets may be listed at par value if cost and par are the same, assets of a similar character may be grouped and profit or loss figures on sales omitted. In other words, provided the STIF guidelines are met by the fund trustee, the fund does not have to be marked to market nor do the statements have to be prepared at market value.

Covered Call Option Fund - Each participating account must contain authority for investment in the bank's covered call option collective investment fund unless the fund is established under Revenue Ruling 81-100 which requires incorporation by reference. The fund should provide a specific method for valuing options.

Foreign Securities Investment Funds - Each participating account must contain specific authority to invest in the bank's Foreign Security Investment Funds unless the funds are established under Revenue Ruling 81-100 which requires incorporation by reference. Where custody of the securities is maintained outside the jurisdiction of the District Court of the United States, the requirement of Section 2550.404(b)(1) of ERISA must be met. If the securities are not held in foreign branches of U.S. chartered banks, the bonding requirements of ERISA 412 must be met.

Real Estate Investment Funds - The plan for such funds if established under 9.18(a)(2), may specify a period of time, not exceeding one year, for prior notice of withdrawal. Real estate must be valued at market, based on an appraisal not older than one year.

Index Collective Investment Funds - The assets of such funds are structured proportionately to a recognized financial index, e.g., Dow Jones, but may not include own-bank securities or securities of an affiliated holding company even though such obligations may be included in the index.

Accounting for common trust funds must be performed on two separate bases; accounting for the fund itself reflecting securities transactions and income, and participant accounting. Each collective fund is set up on the trust accounting system as an individual account. The actual day-to-day processing is the same as other fiduciary accounts. Participant ledgers, maintained on either a manual or automated system, contain the records of each individual account's holdings in the common trust fund reflecting the number of units acquired or disposed of, original unit cost, proceeds from any redemptions and balance of units held.

The market value of the fund must be determined at least quarterly. The unit value of the fund is determined by dividing the total number of units

in the fund into the market value on the valuation date. Units are invested or redeemed at the unit value as of the valuation date. Income is distributed according to the unit value of income.

The total income earned and accrued (how income accrued is determined by the plan) is divided by the total number of units and paid accordingly or in the case of fund for employee benefits accounts, may be reinvested. The Comptroller's regulations require that unit values be determined and that the posting of entries related to purchases and redemptions of units and the distribution of income be completed within ten business days after the valuation date.

C. APPLICABLE LAWS AND REGULATIONS

In addition to Regulation 9.18 of the Comptroller of the Currency, common trust funds are also governed by the following laws and regulations.

Securities Act of 1933 - Section 3(a)(2) of the Securities Act of 1933 generally exempts from the registration requirements and other provisions of the Act any interest or participation in any common collective investment and reinvestment of assets contributed thereto by such bank in its capacity as trustee, executor, administrator or guardian. Section 3(a)(2) also contains an exemption for interest in collective trust funds maintained by a bank for stock bonus, pension or profit sharing plans which meet the requirements for qualification under Section 401 of the Internal Revenue Code. The exemption from registration in Section 3(a)(2) does not extend to collective funds containing plans which cover employees some or all of whom are employees within the meaning of Section 401(c)(1) of the Internal Revenue Code. Section 401(c)(1) of the Code pertains to HR-10 or Keogh Act Plans or Trust. In addition, the exemption from registration in Section 3(a)(2) does not cover IRA's, which qualify as pension plans under Section 408 of the Internal Revenue Code. The 3(a)(2) exemption applies only to pension plans qualifying under Section 401 of the Code or annuity plans qualifying under Section 404.

In January 1981, the Division of Corporate Finance, Securities and Exchange Commission, reversed an earlier position and indicated that Keogh funds may be commingled with corporate

funds without the participation of the corporate funds having to be registered under the Act. The Keogh participation, however, would have to be registered unless exempted by statute, such as by the intra-state exemption in Section 3(a)(11) or by Commission rule or order. Section 3(a)(11) provides an exemption from the registration requirements for any security which is a part of an issue offered and sold only to a person resident within a single State or Territory where the issuer of such security is a person resident or doing business within, or, it a corporation, incorporated by and doing business within, such State or Territory. For the intra-state exemption to be available, all of the interests in the commingled fund must be sold intrastate. The commingling of intrastate Keogh plans with interstate corporate plan assets precludes the 3(a)(11) exemption.

Rule 180, recently adopted under the Act, provides an exemption from registration for an interest in a single trust fund or in a collective trust fund maintained by a bank for a Keogh plan under certain circumstances. To qualify, the employer must either be a law firm, accounting firm, investment banking firm pension consulting firm or investment advisory firm, engaged in furnishing services of a type involving such knowledge and experience in financial and business matters that the employer is able to adequately represent its employees, or must have independent expert financial advice before adopting the plan. The independent advisor cannot be a financial institution providing a funding vehicle to the plan. In addition, to qualify for the exemption, the plan must cover only employees of a single employer or employees of interrelated partnerships.

In 1978, the Securities and Exchange Commission revised its definition of a common trust fund to permit multi-bank holding companies to operate, through a lead bank, one common trust fund for all banks in the holding company system rather than requiring separate common trust funds in each bank. The examiner will still need to determine if State law permits such an arrangement.

Investment Company Act of 1940 - The Investment Company Act of 1940 (Act) regulates the activities of investment companies with requirements that include registration and annual statements. Section 3(a) of the Act defines an investment

company as an issuer engaged primarily in investing, reinvesting or trading in securities, e.g., a mutual fund. Section 3(c)(3) provided that the Act does not apply to any bank common trust fund or similar fund maintained by a bank exclusively for the collective investment and reinvestment of monies contributed thereto by the bank in its capacity as trustee, executor, administrator or guardian. Other pooled funds are not exempted by Section 3(c)(3) even though they are operated by a bank.

Section 3(c)(11) of the Act exempts the following from the definition of an investment company; employee's stock bonus, pension or profit sharing trust which meets the requirements for qualification under Section 401 of the internal Revenue code of 1954, and any collective trust maintained by a bank consisting solely of such trusts. The exclusion does not include IRA's which qualify under Section 408 of the Internal Revenue Code.

Some banks may wish to commingle employee benefit plans with common trust funds on the theory they are acting as trustees in both instances. However, such commingling could cause the resulting pool of funds to be subject to the Investment Company Act of 1940. Such a commingled fund could not be exempt under Section 3(c)(11) because that Section exempts only collective trust funds consisting solely of assets of various employee benefit plan trust qualifying under Section 401 of the Internal Revenue Code. In addition, the Securities and Exchange Commission has interpreted the phrase "common trust fund" as applying only to those common trust funds maintained by a bank exclusively for the collective investment and reinvestment of funds contributed thereto by the bank in its traditional capacity as trustee, executor, administrator or guardian. Such a commingled fund, combining personal trusts and employee benefit trusts, may not come within the Section 3(c)(3) exemption. Common trust funds for personal trusts and pooled investment funds for employee benefit accounts generally have different investment objectives and policies. It would be most unusual to have the same investment policies for tax exempt trusts governed by ERISA as for taxable private trusts.

Because of the securities laws and as a practical matter, personal trust assets, employee benefit

trust assets and Keogh trust assets are generally not commingled. In instances where they have been combined, the examiner should determine whether a violation of the securities laws exists.

Although a common trust fund may be exempted from the registration requirements by virtue of the exemptions in the Securities Act of 1933 and Investment Company Act of 1940, the purchase or sale of interests in a common trust fund would be subject to the general antifraud provisions of the securities laws.

Glass-Steagall Act (Banking Act of 1933) - The Glass-Steagall Act (Act) established the Federal Deposit Insurance Corporation. In addition, The Act required financial institutions to restrict their securities activities. A description of the Act is included in Appendix C of the Manual. In 1971 the U.S. Supreme court ruled in the Investment Company Institute (ICI) vs Camp, 401 US 617 (1971), that Section 21 of the Banking Act of 1933 (Glass-Steagall Act) prohibits a collective investment for agency accounts. A national bank had offered a commingled fund for managing agency accounts approved by the Comptroller of the Currency. The court decided the bank was competing with mutual funds in violation of the Act, and as a result of the decision collective funds for managing agency accounts are prohibited in the trust and investment divisions of commercial banks.

The examiner must determine whether or not an account is an agency account. Agency accounts are defined as those created by an agreement wherein the bank may be granted the right of discretionary purchase and/or sale of assets, or investment may be subject to the client's approval or recommendation. Unlike trusts, full title to the assets remains in the principal's name and reverts to the individual's estate at death.

If, during an examination, it is disclosed that agency account funds have been invested in one of the bank's collective funds for personal accounts, a violation of Section 21 of the Banking Act of 1933 should be scheduled in the report of examination. Similarly, the same requirement is in place by virtue of definition of a common trust fund under Section 9.18(a)(1) of the Comptroller of the Currency's Regulation 9. Examiners may elect to use this citation for purposes of scheduling

such violations. The examiner should request that all such agency account funds be withdrawn at the next valuation date. In addition, since such an investment would have been illegal when made or allowed by the bank, the accounts should not suffer any loss upon withdrawal. Any loss should be reimbursed by the bank.

State Statutes - Common law places restrictions on commingling. All states and the District of Columbia now have enabling legislation which permits operation of collective funds. Many states have also adopted the Uniform common Trust Fund statutes which authorize the commingling of account investments and relieve the co-fiduciary of responsibility for investments in the funds.

State law may include additional requirements exceeding those imposed by Section 9.18 of the Comptroller of the Currency's Regulation 9, such as a requirement to furnish periodic accountings to a particular court and/or the State supervisory authority. When not required by law or regulation, regular accountings should, nevertheless, be compiled for each common trust fund and made available to all interested parties.

Department of Labor - Section 408(b)(8) of ERISA provides an exemption from the prohibitions in Section 406 for any transaction between a plan and a common or collective trust fund maintained by a party-in-interest which is a bank or trust company supervised by a state or Federal agency, provided the transaction is a sale or purchase of an interest in the fund, the bank or trust company receives not more than reasonable compensation, and the transaction is expressly permitted by the instrument under which the plan is maintained or by a fiduciary (other than the bank or trust company or an affiliate thereof) who has the authority to control and manage the assets of the plan.

The Department of Labor granted a class exemption for bank collective investment funds (80-51) which permits bank-maintained collective investment funds, with employee benefit plan participants, to do business with plan-related parties under certain conditions. For related party transactions occurring on October 23, 1980 or thereafter to qualify for the exemption the plan must have less than a 5% interest in the total assets of the fund. Prior thereto the limitation was 10%.

Internal Revenue Service - Inasmuch as collective trust funds are trusts, they are subject to Federal income tax. However, Section 584 of the Internal Revenue Code grants tax exempt status for common trust funds (collective funds established under Section 9.18(a)(1) of Regulation 9) provided they are administered in accordance with the regulations of the Comptroller of the Currency. Pooled investment funds (collective funds established under Section 9.18(a)(2) of Regulation 9 or Revenue Ruling 81-100) are generally exempt from taxation under Section 501 of the Internal Revenue Code.

Internal Revenue Service regulations require that a bank operating either common trust funds or collective investment funds file annual informational tax returns for such funds (Section 6032 of the Internal Revenue Code). The returns are filed on Internal Revenue Service Form 1065, Partnership Tax Return. Current Internal Revenue Service regulations do not require that a copy of the fund be submitted to the Internal Revenue Service with the annual informational tax return. However, if the plan document is or has been previously supplied and the plan is amended, it is required that a copy of the amendment be filed with the tax return for the year in which the amendment was adopted.

The Internal Revenue Service does not require that common trust fund plan documents be submitted for determination as to qualification as a tax-exempt entity prior to formal operation. However, it is recommended the bank submit such plans as well as any substantive subsequent amendments to the Internal Revenue Service requesting a tax-exempt qualification determinations letter.

D. EXAMINATION PROCEDURES

The examiner should determine that the plan's provisions and operation of the fund are in compliance with the provisions of Section 9.18 of Regulation 9 of the Comptroller of the Currency as well as applicable Federal and local laws. The examiner's review should include the plan and any amendments thereto, and the last audit report, financial report and valuation statement. The examiner should ascertain that investments are of fiduciary quality and portfolios are consistent with the investment policies stated in the plan. A determination should be made that records are

adequate to properly reflect the interests of all participating accounts and the purchase and sale of investments. A sampling of individual accounts participating in the fund should be reviewed to determine whether or not purchases of fund units have been properly authorized by co-fiduciaries, if applicable, and are in accordance with the investment provisions of individual agreements as well as applicable Federal and State laws and regulations. Any violations of Regulation 9.18 or other applicable laws should be fully discussed with management and scheduled in the report of examination.